An Inside Look at Hedge Funds

An Honors Thesis (HONR 499)

by

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Abstract

Hedge funds are a large part of the modern financial system and make up a significant portion of the alternative investment space. The strategy a hedge fund runs is important because it determines the objective and return of the fund. These strategies use different models and projections in order to accomplish various goals, based on the investor's preferences. Essentially, it is the strategy of a hedge fund that leads it to produce returns for the investor; without the strategy, hedge funds would not have a deliberate plan as to how to invest. These diverse strategies are able, and have been proven, to deliver very high returns and have been shown to outperform traditional investments. I analyze many of these hedge fund strategies and explain what makes each of them run successfully, exploring the various purposes and structures of each.

Acknowledgments

I would like to thank Dr. Joseph Goebel for advising me through this project. His help and expertise in this area helped me with the initial outline and subsequent ideas and edits for this project.

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Process Analysis Statement

For this project, I consulted multiple books on different aspects of the hedge fund industry. Even though the books covered the same general topic, the information varied greatly, and I was able to obtain a broad range of information that helped diversify the paper. I bookmarked different parts in each book that I thought would be the most useful, and then took notes on these portions. I paid special attention to direct quotations I wanted to use from the author, and included the ones I thought most enhanced the topic.

During the writing process, I made sure the technical aspects of the topic were not overly complicated to understand for the average reader. This was a somewhat complicated task, as some aspects of this project were quite technically written in the books. My goal when writing was to write it in a way so that anyone who read my thesis could learn about hedge funds – what they are and how they are used. Thus, I attempted to make the information in this paper accessible and easy to read for anybody who wished to learn more about hedge funds.

This project greatly enhanced my knowledge of the inner workings of hedge funds, which is an industry I plan to work for in my upcoming role as a Financial Analyst at Goldman Sachs. I enjoyed learning about the different facets of the industry and the numerous strategies I had not known about prior to my research. I chose this topic because I knew it would be of help to me as I began my career. This project has been an excellent learning experience for me, and has better prepared me for my future.

Introduction

Hedge funds are often seen in the news, usually depicted in a negative light involving fraud, high fees, and overall problems associated with investing in them. It is true that "hedge funds are without a doubt the most controversial sector of the worldwide investment industry" (Kirschner et al. 301). Generally speaking, the term "hedge" means to cover or spread risks. There is not one specific definition for the words "hedge fund," as different sources offer different definitions. A simple financial definition of a hedge fund is a fund that uses non-traditional management strategies (Capocci 1). Moreover, when examined closely the evidence suggests that hedge funds are associated with lower volatility and improved portfolio performance. Each fund is unique, with a distinctive set of managers running a specific and specialized investment strategy. Thus, each strategy employed is responsible for the overall performance and returns of any particular fund (Kirschner et al. 301).

Hedge funds have come a long way since the 1990s; they have ventured from being investment vehicles primarily available to the wealthy to now being available to institutional investors whom greatly value them in their portfolio. With the growing popularity of hedge funds, government regulations of their operations have changed. As a result, hedge funds have added certain elements to their management structure such as risk management, marketing, operations, and compliance (Zask xix).

Before the housing crisis of 2007, hedge funds "enjoyed a tailwind of falling interest rates, economic expansion, and increased tolerance for leverage and derivative structures" (Zask xx). The environment of falling interest rates and lenient credit standards led to an increase in asset valuation in the markets, particularly bond markets. In response to these conditions, hedge funds revised their investment strategies. Because the economic environment has changed since then, with lower interest rates and unpredictable markets, returns of hedge funds have decreased (Zask xx). Many people lost hope in the hedge fund industry during the credit crisis, after which hedge funds in aggregate lost 20% (Zask xxi).

Traditional investments involving positions in stock and bonds that also include hedge funds are referred to as "alternative investments." There are notable advantages of hedge funds, as they have been deemed to produce risk-adjusted returns superior to traditional investments. In addition, hedge funds offer protection from market crashes and reduce risk through portfolio diversification (Zask xx). For many investors, it was a rule of thumb that "anywhere from 5% to 20% of a portfolio should be invested in hedge funds" (Zask xx). This theory has been heavily challenged by critics claiming that hedge fund performance and return analysis are meaningless. Proponents of hedge funds maintain that these funds are associated with alpha returns, also referred to as excess returns. Excess returns are returns above the appropriate risk-adjusted returns; however, this claim by proponents has been refuted over the years by critics, whom claim that most of the return goes directly to the managers with little return to investors (Zask xx-xxi).

There are two main ways hedge funds fit into the overall financial system. First, a hedge fund is "often seen as part of the so-called shadow banking system of interconnected actors that includes bank vehicles, sovereign wealth funds, hedge funds, and private equity firms and that is 'greased' by leverage and collateral" (Zask xxi). "Greased," in this instance, refers to how returns are enhanced through the use of leverage. Second, because hedge funds are very important to the financial markets, they are now being more closely scrutinized and regulated which runs counter to the general public perception of hedge funds being unregulated investments (Zask xxi).

History

The first time the words "hedge fund" appeared publicly was in an article in *Fortune* magazine in 1966. The author asserted that this new type of investment vehicle continued to outperform the best-performing mutual funds such as the Fidelity Trend Fund and Dreyfus Fund by as much as 87% (Capocci 7). This mysterious investment vehicle was coined the term "hedge fund," because it illustrated the investment strategy in which it operated (Capocci 7). Due to the popularity of the article, there was an increase in the number of hedge funds during the 1960s (Capocci 8).

Prior to 1966, the first hedge fund was established in 1949 by Alfred Winslow Jones, an attorney in New York (Kirschner et al. 29). He created a fund called A.W. Jones & Co. with four friends with only $100,000 in assets under management (Capocci 7). The characteristics of Jones's fund, still seen in hedge funds to this day, include selling short, using leverage, and avoiding requirements of the Investment Company Act of 1940 through establishment of a limited partnership structure. Performance fees and management fees were implemented as Jones took 20 percent of the profit of the fund along with a management fee (Zask 82).

The strategy the fund ran was simple, yet clever. Essentially, he longed a portfolio of stocks, which were in turn hedged by a portfolio of shorts. The stocks that were chosen to be longed were attractive investments, while the stocks that were chosen to be shorted were considered unattractive investments. Since the notion was that in good market conditions the longs would increase in price more than the shorts, there would be a profit. However, if the market conditions were poor, the price of the longed stocks would decrease less than the shorts, which would also produce a profit (Kirschner 29).

Jones's idea was to maximize returns by reducing the level of market risk by combining long and short positions (Capocci 6). The main objective of forming this investment vehicle was to minimize risk. Essentially, Jones implemented long and short equity positions to hedge the exposure of the fund to movements in the stock market (Zask 3). Jones's goal was not to create a complex product, but one with a risk-reduction strategy that could be understood and applied by many other investors, and he hoped it would become standard in the future (Capocci 7). The fund was very successful and other investors tried to imitate it by following his model with the limited partnership structure and fee arrangement (Zask 82). Jones hired managers and handed most of the business over to them in 1952 while he mainly focused on supervising and monitoring the investment activities and operations of the fund. Thus, the fund turned into a multi-manager fund (Stefanini 2).

The market fell in 1970 and significantly damaged the hedge fund industry, decreasing the assets in the industry by almost half. The twenty-eight largest hedge funds of 1969 lost seventy percent of their assets, as sited by the Securities and Exchange Commission (Capocci 9). Five of these funds were forced to close. It was not until 1974 that hedge funds became popular again, but even then there were only sixty-eight operating hedge funds. Toward the end of the 1980s, the hedge fund industry was particularly interested in the preferred strategy of the largest hedge funds that focused on macro funds (Capocci 9). Notably, "in 1990, around 70 percent of the assets of the industry were invested in macro funds according to Hedge Fund Research, Inc." (Capocci 9). Beginning with the 1990s and over the next twenty years, the number of hedge funds rapidly increased by a multiple of ten before dipping down during the 2008 liquidity crisis and consequent recession. Since then, they have recovered to prior levels (Capocci 9-10).

Hedge Fund Characteristics

The main characteristics of Jones's hedge fund are still seen in hedge funds today. The three principles Jones used to categorize hedge funds include operating from a private company, using leverage, and paying performance-related commissions. However, today there are a broader range of characteristics that are captured under the umbrella term of "hedge fund," as the strategies are now more complex and no longer limited to the three original principles identified above (Capocci 8). Today, there are many characteristics that are shared by hedge funds, but not every fund has every characteristic. However, "these features do represent a definable group of entities that most industry participants would recognize as hedge funds" (Zask 3).

The formation of hedge funds is rather unique. They are typically established as either a limited partnership, which issues shares to limited partners, or corporation. There are no real employees of the fund, but only a general partner who is typically the creator of the fund, along with investors. The investors, also known as limited partners, offer capital in exchange for ownership in the fund (Zask 7-8). Unlike mutual funds, hedge funds are neither offered to the general public nor subject to marketing or advertising of any sort. Rather, hedge funds are only offered privately to certain investors who meet regulatory criteria. Investors must meet certain requirements in order to invest, which makes them a "qualified investor" or "accredited investor," based on numerous factors such as wealth, income, sophistication, and their ability to incur large monetary losses. Due to the strict investor qualification requirements, qualified parties are typically high net-worth individuals or institutions (Zask 9).

Because the hedge fund industry is largely unregulated relative to the mutual fund industry, it does not have to register with the Securities and Exchange Commission. Thus, unlike mutual funds, there is no prospectus. Instead, hedge funds provide a document called a private placement memorandum, otherwise known as an offering document (Zask 9). The U.S. Investment Company Act of 1940 requires that hedge funds issue this document. The offering memorandum, given to investors when the fund is interested in raising capital, discloses the material terms of the interests of shares being offered, the details of the general partner, information about the investment advisor, material risk factors for an investment in the fund, tax aspects, regulatory matters, and information about the administrator and fees (Zask 25). The fees shown in the offering document are described and their calculations are shown (Zask 26).

Implementing marketing tactics and gaining clients is quite difficult for hedge funds because they can only seek investments from potential investors who have a preexisting relationship with them (Zask 25). To do this, the fund has to either contact the investor before sending the investor the offering memorandum or hire a marketer or broker-dealer, registered with the Securities and Exchange Commission, to solicit preexisting relationships of the hedge fund (Zask 25). Investors who are interested in investing in a specific fund have access to documents including disclaimers and information regarding the proposed strategy, risk, and background of the fund (Zask 26).

There are numerous strategies hedge funds can run that reflect "how the manager will invest, the markets and instruments that will be used, and the opportunity and return source that will be targeted" (Nicholas 16). Potential investors are also given a variety of marketing materials, which include newsletters and PowerPoint presentations, in addition to meetings and phone conversations with the fund managers (Zask 24). These documents include information regarding the investment program, structural terms, management company, past results of the fund, various management and performance fees and expenses, and warnings to investors that there is risk involved in the investment (Zask 26). Some of the documents are negotiable, particularly by attorneys hired by institutions to review the documents of the fund (Zask 24-25).

The Securities Act of 1933 and the Investment Adviser Act of 1940 are two of the major laws that govern the investment management industry. Hedge funds, due to their unregulated nature, are exempt from most of these laws. Most notably, hedge funds are not registered under the Securities Act of 1933. However, hedge funds must adhere to the Dodd-Frank Act that states that any hedge fund with greater than $150 million in assets under management must register with the Securities and Exchange Commission and disclose certain information (Zask 9). Even though the hedge fund space is left largely unregulated, it is still subject to laws that prevent fraudulent practices such as insider trading and managerial scheming (Zask 10).

Another characteristic of hedge funds is the restricted redemption rights of investors. Hedge fund shares are set up to only be redeemed (cashed out) periodically, such as annually or quarterly. In addition, the investor must notify the fund manager if he wishes to redeem, and in many instances must notify the fund in advance if the investor intends to redeem in the near future, which is called a notice period (Zask 10). The redemption rights of hedge funds differ by fund. Certain funds will allow the investor to have early redemptions in exchange for a penalty fee of 3-5 percent of the amount the investor wants to redeem (Zask 28).

The general partner of the fund has the ability to suspend the redemption period or lock up the entire portfolio until he wants to allow redemptions (Zask 10). General partners have wide discretion regarding the fund's redemption rights, so the restrictions are written in broad terms in the offering documents so that the general partner has the flexibility to choose the restrictions (Zask 28). For instance, an offering memorandum may read as the following: "The General Partner, in its sole and absolute discretion, has the right to suspend withdrawals by Limited

Partners under certain circumstances…" (Zask 29). Clauses such as these allow the general partner to have a broad range of discretion.

The basic structure of hedge funds remains consistent through all hedge funds; however, hedge funds differ in that "each hedge fund manager is a specialist pursuing a very specific investment approach called the investment style or strategy" (Nicholas 23). Hedge fund managers pursue various hedge fund investment strategies for different reasons, as "an investment strategy is an approach to selecting securities, or a portfolio of securities, based on an investment philosophy designed to derive returns by taking unique risks in the financial markets" (Nicholas 23-24).

Equity Long/Short Strategy

Jones implemented an equity long/short strategy, which is one of the most popular hedge fund strategies today: "according to the LIPPER TASS database, on 31st December 2004, long/short equity funds represented 33% of the whole sector" (Stefanini 47). Funds that follow this strategy "tend to be net long (meaning that their portfolios have a positive exposure to the stock markets) under the assumption that stocks increase in value over time" (Zask 176). In equity strategies, fund managers either approach their strategies from a top-down or bottom-up approach. In general, most funds use one approach more often than the other, although in some cases a fund can utilize both approaches. The top-down approach begins with an economic analysis, such as the state of economic growth. The fund manager then chooses securities that are in line with the assumption of the analysis, and invests accordingly. On the flip side, the bottom-up approach begins with the securities themselves, in which the manager will long perceived undervalued stocks and short perceived overvalued stocks (Zask 176).

The process by which investors evaluate stocks in a bottom-up approach involves a high degree of quantitative analysis. In this way, they decide which stocks are undervalued or overvalued, and then invest accordingly. Quantitative analysis includes evaluating a slew of financial ratios such as price-to-earnings, price-to-book, dividend yield, etc. (Zask 176). Managers can look at historical trends and gain insight regarding what way the price of a security may move in the future. Qualitative analysis involving economic environment or competitor information is also important. Fund managers may meet with company managers to gain more insight on the company and to aid in the stock selection process (Zask 176).

There are several characteristics that set apart a long/short strategy. First, managers of long/short funds seek performance uncorrelated with market performance (Stefanini 47). As

Jones demonstrated, hedge fund managers "look for shares that they believe the market is undervaluing, as well as shares they perceive are being overvalued, then they buy the first (long position) and short sell the second ones (short position)" (Stefanini 47). The hope is that the long positions increase in value and the short positions decrease; if the opposite were to occur, the fund manager experiences a loss. Second, the selected stocks are unique and reflect sectors including healthcare, retail, industrials, technology, financial services, etc. Further, a long/short strategy fund may place emphasis on a certain country such as Brazil, the United States and Russia. However, most focus primarily on the largest and most liquid stock markets such as the United States, Japan, and the United Kingdom in deciding where to hold positions (Zask 177). If a fund invests in stocks of a rather illiquid market, it may face liquidity issues. Since accounting standards broadly differ across countries, there may also be transparency issues when investing in certain countries (Zask 177).

Managers running a long/short strategy have a variety of investment styles. An investment style is distinguished by market capitalization and value-versus-growth prospects. Market capitalization reflects the total market value of common stocks of a firm and is defined as large, medium or small. Large-cap stocks tend to be more liquid with lower returns whereas medium and small-cap stocks tend to be less liquid with higher returns (Zask 178). In distinguishing between value and growth-oriented firms, managers seeking to hold value firms will first use quantitative analysis to price individual securities in order to identify securities that are currently trading at a relatively lower (undervalued) price, and then enter into long positions with these undervalued securities. Value stocks usually involve taking positions in established companies with long track-records in mature industries such as healthcare. In contrast, managers seeking growth are more focused on the future growth prospects of stocks. These managers are willing to bypass dividend cash flow streams for stock price appreciation over time as the company grows (Zask 177). One sector typically identified as growth-oriented is the technology sector.

There is still a debate over whether growth or value stocks perform better, but this comparison is inappropriate because growth stocks and value stocks have different characteristics. Growth stocks are typically associated with higher betas; thus, these stocks move more dramatically in the direction of the market than value stocks. Value stocks are attractive to many investors and are usually lower beta stocks; thus, these stocks are not as influenced by the market and typically pay more in dividends than growth stocks (Zask 177).

Equity Market Neutral Strategy

Equity market neutral is a hedge fund strategy in which computerized models build distinctive portfolios. The portfolios consist of several simultaneous long and short positions and each portfolio is essentially designed to be "neutral or largely immune to fluctuations in the larger marketplace as well as to other factors such as economic growth and interest rates" (Zask 186). With these portfolios, performance solely relies on the long and short positions of the securities in which the fund invests. While these funds are highly levered, managers believe the risks associated with leverage are inconsequential because the fund is immune to market exposures involving market beta, sector, industry, or market capitalization (Zask 186).

In forming an equity market neutral portfolio, managers focus on stock selection and portfolio construction (Zask 186). The stock selection and portfolio construction process involves managers screening stocks based on liquidity and ability to be shorted. During this process, many sectors and stocks are eliminated and the end result lists investable stocks that match the screening criteria of the manager. The manager then decides from these stocks which to long and which to short. In order to select the stocks, managers examine three factors: fundamental factors, price momentum, and expectation factors (Zask 187). Thus, equity market netural managers ensure that the portfolios are beta neutral, meaning they are insulated from market swings (Kirschner et al. 139).

Fundamental factors involve calculating the intrinsic value of a stock through quantitative and qualitative analysis and then comparing it to the current price of the stock, thus determining if it is overvalued or undervalued. The dividend yield, earnings yield, revenue growth, and return on equity are among the most widely used measures to evaluate the intrinsic value. In this way, the manager can exploit the current market price of the stock and gain a profit. Another factor is price momentum, which studies the tendency of price movement of a stock (Zask 187). Relative strength indicators and a trend line can be used in determining this. Lastly, expectation factors exploit the difference between the expectation of a stock's forecasted earnings versus its actual earnings (Zask 187). The three-year prospective earnings growth rate and twelve months prospective earnings yield are used in considering the expectation factors (Zask 188).

One of the advantages of the market neutral strategy is that it provides immunity to shocks in the stock market and has low correlation to the stock market, which makes it a good contender for diversification in a portfolio. However, this strategy has been known to produce "disappointing returns, which is a result of the difficulty of finding stock-specific anomalies that can be profitably exploited" (Zask 188). In order to be successful in the equity market netural strategy, the manager must have a superior stock-picking ability. There is a significant risk if the stocks selected do not behave as predicted because the portfolio formed will reflect more idiosyncratic risk than market risk in performance (Kirschner et al. 146).

Instead of beta-driven investing, this strategy makes money through analyzing the companies in which it invests, either longing a stock or shorting it, depending on the manager's analysis. Thus, if the longs don't increase more in value than the shorts decrease in value during market upturns and/or the shorts don't increase in value more than the longs decrease in value during market downturns, the portfolio will not even outperform the risk-free T-bill rate. It is important to note that with this strategy, when shorts are sold, the cash is invested in T-bills, and the profit goes to the manager. This is known as the "monkey return" because this source of return requires no skill (Kirschner et al. 141-142).

Event-driven Strategy

Event-driven strategy funds take positions on events such as bankruptcies, mergers, or corporate restructurings (Zask 195). Three types of funds typically run this strategy: activist hedge funds, merger arbitrage funds, and distressed investment funds. First, activist hedge funds invest in many shares of a certain company in hopes of altering the company's management decision or strategy through control of the board of directors. The goal is to affect the company in a way that the company's value will increase, resulting in an increasing share price. However, the company invested in is perceived as undervalued by the fund and, therefore, is not performing as well as it could be according to the opinions and calculations of the fund. This strategy typically has a six-month to two-year investment horizon (Zask 195). These funds have historically outperformed fixed-income indices relative to performance and volatility. However, they significantly underperformed from 2007 through 2011, which was most likely a result of the unpopularity these illiquid securities faced during the credit crisis (Zask 204).

In changing certain elements of the company, the investor hopes to reap positive rewards as the value of the company increases. There are four different aspects the investor may choose to change about the company. One of the ways the investor can hope to create value for the company is through financial restructuring. Financial restructuring involves making adjustments to the company's balance sheet through either reducing excess cash or changing the leverage structure. Another is operational turnaround, which involves increasing operating margins by reducing costs or applying various revenue-enhancing techniques (Zask 196). Third, strategic turnaround involves strategic moves by the company like mergers and acquisitions or spin-offs of different product lines the company may own. Fourth, corporate governance involves changing the composition or incentive of the management team, which can greatly influence the way the company operates (Zask 196). In all of these ways, the end goal of the investor is to create value for the company in hopes that the company's share price increases, thus increasing investor profits.

An investor using the activist strategy follows certain steps in order to effectively utilize the strategy. The funds originate when the investor buys a small position in a target company, providing access to information and creating an incentive for the company's managers to enter into discussions (Zask 197). The activist strategy works best in small to mid-cap companies, because investors have a higher chance of influencing managers that may be more inexperienced as well as being able to invest in a smaller share of a company and have significant power, compared to a large-cap company (Zask 197). From there, the investor slowly purchases more of the company's stock, thus receiving more influence over the value creation capabilities of the company. In this way, the fund may be added to the target company's board of directors. However, "in the United States, a shareholder who acquires more than 5% share in a public company is required to file a Schedule 13D with the SEC within 10 days" (Zask 197).

After the fund gains influence with the target company, the investor discusses with management value creation capabilities and forms a plan to improve the value and therefore share price of the company. It is important to note that communication between the manager and investor can be conducted in either a hostile or non-hostile manner; hostile situations typically involve proxy fights, competition for board seats, takeover bids, and usually creates publicity (Zask 197). Activist funds usually have a portfolio with between eight to fifteen positions and invest with a time horizon of about six months to two years, matching liquidity terms to this horizon. These funds typically have a long bias, although they may take short positions with an index or basket (Zask 197).

The second event-driven hedge fund strategy is the merger arbitrage strategy. Merger arbitrage funds "take a long position in a company about to be acquired and a short position on the acquiring company seeking to profit from the convergence of the shares' prices" (Zask 195). The manager's objective is to capture the spread between the current stock market prices and the value of the shares once the merger is completed (Zask 198). Therefore, the profit is connected with the state of the economy as well as the condition of the stock market because this strategy is reliant on the level of mergers and acquisitions being made. Losses in the fund's long position may occur if the price of the to-be acquired company declines, which could happen if the transaction does not go through, resulting in the stock prices reverting to pre-deal announcement prices (Zask 199). Unfortunately, general merger and acquisition activities of companies have slowed down due to depressed economic environments. In addition, companies have kept higher levels of retained cash and as a result, these funds have not been performing as well as they were intended to (Zask 199).

The third type of an event-driven hedge fund is called a distressed investment fund. Distressed investment funds "invest in the securities that are in bankruptcy, are expected to enter bankruptcy, or are coming out of bankruptcy" (Zask 199). These funds find success through investing in distressed securities because no other investor is investing in them and are often avoided because they appear unattractive. Because of lack of investor interest in these certain companies, the securities can be undervalued (Zask 199). With corrective steps, these opportunities can be quite profitable. Because the credit default swap market has grown in recent years, many distressed strategies involve the use of credit default swaps (CDS) as hedges against the security in the distressed company (Zask 200). A CDS is when two counterparties exchange the risk of default for periodic income payments. The lender seeks protection in the event the borrower defaults, so a CDS is essentially insurance for that risk ("Credit"). Thus, a hedge fund could purchase the debt of a distressed company, but also purchase a CDS on the company, shifting the default risk onto the CDS. The CDS would pay the hedge fund if the company defaulted on its debt (Zask 200).

Fund of Hedge Funds Strategy

In the discussion of hedge fund strategies, it is necessary to discuss the fund-of-fund (FoF) strategies, which are pooled investment vehicles that invest in individual hedge funds (Kirschner et al. 243). A man named Richard Elden and his team at the Chicago firm Grosvenor Capital Management, LP introduced FoFs in 1971, but did not originally invent them. The invention of FoFs is accredited to the Rothschild family in Europe, who started the first FoF called Leveraged Capital Holdings in 1969. This fund still exists and manages around $1.3 billion by running an equity long/short strategy primarily in United States equities (Kirschner et al. 243).

FoFs were advantageous to investors because they "offered investors a chance to reduce their risk by investing across all hedge fund strategies and in funds that were relatively uncorrelated to one another" (Kirschner et al. 243). Investors are interested in investing in FoFs because they believe they are an efficient and cost-effective investment vehicle. Further, managers investing in FoFs can skip having to carefully choose which hedge funds to invest in individually and invest in one FoF instead (Nicholas 3-4). FoFs have become the "most common means of access for investors who are looking for diversified exposure to hedge funds, but who do not have the resources to research, monitor, and manage multiple hedge funds" (Nicholas 6).

By selecting external fund managers and building a diversified portfolio, FoFs achieve a high level of diversification in terms of strategies, asset managers and liquidity profiles, where "the objective of such strategy is to obtain a diversified product by investing in a single product that is fully diversified" (Capocci 347). FoFs diversify away multiple risks by combining various investment strategies and funds with different levels of risk, profiles, and market exposures across the globe (Capocci 348).

Due to diversification, even when one strategy faces challenging times and may prove to be unprofitable one year, the FoF can overall perform well because the balancing of multiple strategies minimizes losses. Compared to individual strategies, FoFs provide stable returns at a lower level of risk (Capocci 348). The selection of the funds are done through a carefully sought-out process, as "fund of funds managers perform a thorough due diligence before making any investment, and they continuously follow the positions they have in portfolio while constantly keeping a lookout for new opportunities; they are fully dedicated to fund-picking and portfolio construction" (Capocci 357).

There has been a growing popularity of FoFs, as "it is estimated that there are more than nine hundred fund of funds in operation today and there are many more being developed. As a group, they represent more than one-third of assets invested in hedge funds" (Nicholas 3). These have become a more popular investment vehicle, as "the annual growth rate for fund of funds assets since 1990 has been 48 percent. This compares to an average annual asset growth rate for the hedge fund industry as a whole of 26 percent" (Nicolas 8). The fact that the growth of FoFs has outpaced the growth of the entire hedge fund industry suggests that FoFs are important vehicles to understand and pursue as an investor. Since the FoF industry is younger than the hedge fund industry as a whole, this industry likely has considerable growth prospects (Nicolas 8).

Due to the diversification of the strategies of FoFs, poor performance of one of the strategies does not typically negatively impact the overall performance of the fund because the effect could be offset by the performance of the other funds. Today, FoFs effectively diversify away most of the risk of investing in single managers (Kirschner et al. 243). The lower volatility these funds offer is remarkable, and they have volatility levels equal to or below those of bonds.

Moreover, investors in these vehicles expect stable returns instead of high returns (Kirschner et al. 243).

FoFs are a private investment vehicle, meaning the securities that these funds offer to investors are not registered with the Securities and Exchange Commission (Nicholas 17). The performance of FoFs is calculated on either a monthly or quarterly basis, but some funds report weekly or even daily performance; however, the industry generally provides only monthly results. There is a wide variety of information that can be reported on the performance result. For example, some provide percentage of profit or loss, and others send investors much more detailed information regarding the fund's activities and subsequent investment results (Nicholas 19). FoFs typically have a minimum investment of between $500,000 to $1 million, but in some instances can be as small as $100,000 and as large as $10 million (Nicholas 18).

Liquidity of FoFs reflecting the time required for investors to redeem their investment varies with funds. If a fund is said to have quarterly liquidity, this means the investor can take money out of the fund at the end of each calendar quarter. Likewise, if a fund is termed to have monthly liquidity, it means an investor can take out money from the fund at the end of every calendar month (Nicolas 19-20). However, there is a notice period to take into consideration; notice periods are the time it takes for a fund to generate the cash for investor redemptions, which can range from thirty to ninety days. These details are all documented in the fund's offering memorandum, which denotes its ability to make payments in either cash or securities (Nicholas 20).

Managers of FoFs must first select funds to invest in. In order to do this, they use qualitative and quantitative criteria and perform due diligence which is mandatory before any investment can even be considered (Capocci 350). The Securities and Exchange Commission has a list of checks for managers to perform before choosing to invest in a fund, including carefully reading the memorandum and other legal documents associated with the fund, checking the commissions, analyzing the liquidity and the limitations that are connected with liquidity, and performing research on the experience of the fund manager. The goal of a FoF manager is to provide stable returns by focusing on low-risk and non-directional strategies. Investors can focus on certain strategies or emerging markets, where the FoFs are invested in hedge funds of different geographical markets for diversification (Capocci 355).

The advantages and disadvantages of FoFs are many. The main advantage of investing in a FoF is the access it provides to the investor; FoFs "enable investors to invest, albeit indirectly, in funds that they would not have had access to individually" (Capocci 357). Also, these vehicles let the manager diversify much of the risk away from the portfolio. Another advantage of FoFs relates to their liquidity. FoFs offer monthly to quarterly liquidity whereas the underlying individual hedge funds can offer liquidity over semi-annual or annual time-frames. In order to provide more attractive liquidity terms to investors, funds keep cash or have access to lines of credit so they are able to provide quick liquidity, especially if the investor requests a large redemption (Capocci 357).

One of the disadvantages of FoFs is the double fee structure. That is, FoFs charge lower fees compared to that of individual funds, but they charge additional fees. There are also management and performance fees, where "fund of funds fees tend to be between 0.5 and 2 per cent management fees, with an average around 1.4 percent, plus a performance fee within a range of 0 to 20 per cent, averaging 10 per cent" (Capocci 357). Overall, the hedge fund industry is more expensive than the mutual fund industry but the difference between these two industry fee structures has narrowed since 2008. Clearly, there is still room for improvement (Capocci 358).

Global Macro Strategy

Another strategy hedge funds can run is called the global macro strategy. Global macro funds "use a wide variety of strategies and instruments to take long and short positions in the global markets for equities, commodities, fixed income, and currencies" (Zask 216). Global macro funds extensively use stock and bond market indices instead of individual stocks and bonds, which is consistent with the strategy's overall focus on broad economic and financial trends. Managers of these funds begin with analyzing forecasts and trends in inflation, economic growth, and interest rate movements, and take positions that reflect the impact these trends will have on the financial markets (Zask 216). For example, a manager could take a position on a specific commodity because he anticipates Chinese economic growth which will influence the demand on this certain commodity. A manager could also take a particular position on the United States dollar/euro exchange rate based on what the manger believes the level of economic growth is going to be for United States and Europe (Zask 216).

Global macro funds are defined as hedge funds even though they do not provide a hedge, but because they are not as limited as mutual funds. Rather than hedging, these funds "seek to profit from the direction of movements on financial markets, establishing directional positions that reflect their predictions in terms of market direction" (Stefanini 240). Thus, the timing of the investment decisions is crucial. These funds can jump from different investment opportunities, ranging from different asset classes (Stefanini 240). Global macro funds have been compared to a chessboard, in which they are "comparable to the queen on the chessboard, the most powerful chess piece who can move in any direction" (Stefanini 240).

Global macro fund managers have a broad investment base; managers can invest in almost any market using any financial instrument. Managers of these funds trade all asset classes, including treasuries, currencies, and corporate bonds, and use a variety of financial instruments such as securities, options, futures, forwards, and indices (Stefanini 239). This wide discretion regarding the markets they trade and instruments they use allow them to successfully respond to the changes in the economic environment (Zask 216-217). Moreover, global macro managers are "active across market sectors, including equities, fixed income, foreign exchange, and commodity asset classes; they utilize cash, futures and/or options; trade in all geographical regions; employ both discretionary and systematic analysis; and frequently use leverage" (Zask 217).

Managers of global macro funds employ a top-down approach in which they analyze the macroeconomic environment and make decisions accordingly. Economic models capture market forecasts and analyze variables such as gross domestic product, public deficit, population demographics, and exchange rates. Fund managers utilize leverage as well as short selling. Most managers invest in commodities, whether it be through derivatives or investing in commodities physically. They do not have limits regarding geographical limitations on their investments; thus, they range from G7 countries to emerging markets to allow them a diversified environment in which to invest and trade (Stefanini 239).

The goal of global macro fund managers is to "anticipate price changes on capital markets and often establish directional positions, i.e. unhedged" (Stefanini 239). Likewise, these investors use a top-down approach to analyze market trends, where each trading decision is based off of the manager's view of the macroeconomic environment. In addition, the manager must follow the risk profile of the fund in order to stay on track with what the investors are expecting from the fund's overall performance. Thus, the overall objective for global macro hedge funds is capital preservation (Stefanini 239).

Recently, the trends and events in currency, interest rate, and commodities markets have appealed to investors to convinced them to pursue global macro funds (Zask 217). Over the past ten years, the number of assets in global macro strategies has dramatically increased. That is, "between 2007 and 2011, the share of hedge fund assets in equity hedge fund strategies declined from 37% to 27%, while the assets in macro strategies rose from 15% to 22%" (Zask 217). The key player of global macro funds is the manager, whose skill and expertise leads them to opportunities that other investors may not have. Thus, the history of global macro funds is usually highly correlated with the experience of the mangers who run them (Stefanini 241). If the manager anticipates price movements correctly, there will be a profit earned. In this way, the "investment philosophy is opportunistic, as they trade in any capital market sector presenting profit opportunities and with any financial instrument, in that they opportunistically replicate the most specialized strategies belonging to the other fund classes" (Stefanini 240).

There are two classifications of global macro strategies: discretionary and systematic. Some global macro managers use both approaches while commodities trading advisors almost always use the systematic approach. The first approach of discretionary strategies is founded on decisions that are made at the discretion of either the manager or investment team (Zask 218). While the manager uses quantitative analysis to establish positions, the ultimate decision is largely based on what convictions the manager has formed from fundamental research regarding financial markets. Managers use data reflecting growth indicators, production indexes, and bank publications in order to develop ideas on how to trade. They may also utilize models that quantify the impact of the economic data on the financial market prices (Zask 218).

Discretionary managers use the "top-down" approach relating economic trends to individual markets. After this, the manager will choose a strategy and instrument that best fits the situation (Zask 218). In the discretionary approach, the judgment of managers is imperative and used to time trades and decide when to enter and exit certain positions; moreover, "the price of markets can be affected very quickly by political or economic events, and discretionary traders typically have complete flexibility of changing, or even reversing, their positions" (Zask 218-219).

In contrast, systematic global macro strategies use computerized models to track the movement of market prices in order to detect patterns that generate buy and sell recommendations. The main characteristic of the systematic approach is that once the model is developed, the manger's role in taking positions ends as the hedge fund automatically follows whatever the model recommends. There is no human intervention, and the programs "focus on highly liquid, exchange-traded futures and options and typically maintain shorter holding periods than discretionary programs" (Zask 222). These programs can be used by discretionary managers in aiding in trade decisions. Thus, the overall goal of systemic global macro funds is to "capture trends in various markets by the use of statistical techniques such as momentum or moving averages" (Zask 223). The program assumes that price movement of a market is enough to form a trading strategy, and that no other information is needed, such as supply and demand or economic trends (Zask 223).

There are numerous benefits associated with global macro hedge funds. One of the advantages is that they provide excellent absolute return to investors. They also act as insurance because they can preserve capital or profit during times of crisis. In addition, because of their low correlation with the equity and fixed-income markets, they act as diversifiers in a portfolio (Zask 224). During the credit crisis, global macro funds performed quite well. As a result, money flowed into these funds in 2009-2010, but they have not lived up to investors' expectations since then (Zask 224). For example, "while global macro hedge funds in aggregate made 8% in 2010, they lost 4.88% in 2011, well behind their hedge fund peers" (Zask 224). Global macro funds were finding the market difficult as market trends in currencies, commodities, and interest rates reversed direction up to several times a month, making it difficult to adequately perform a fundamental analysis (Zask 224-225).

The early years of the 1990s is said to be the golden age of global macro funds, where "in 1990, global macro funds accounted for 71% of the hedge fund industry, according to Hedge Fund Research, whereas at the end of 2004 they were down to only 10%, according to the LIPPER TASS database" (Stefanini 241). Many global macro funds are popular due to their performance and large size of the assets under management. Because they are somewhat secretive and closed off, especially to new investors, they have a mysterious element attached to them (Stefanini 241). Global macro managers are private and often offer limited information to their investors; if they at all discuss performance with the investor, it will be months later and in a general sense. These managers are also particularly known to deny interviews by journalists (Stefanini 239-240).

Projections

There has been an increased interest recently in the alternative investment space, particularly in hedge funds. Hedge funds have proven themselves to be "capable of delivering strong risk-adjusted performance with relatively low correlation to traditional asset classes" (Phillips 174). There is much evidence that hedge funds will continue to play a key role in the development of the entire asset management industry. Recently the hedge fund industry has seen a surge in assets under management as well as the number of funds that are offered to investors. Institutional investors such as pensions, banks, and funds of hedge funds are continuing to make up a large portion of the hedge fund investor base, and should continue to do so in the future (Stefanini 291).

Progress has been made in the hedge fund space regarding transparency, and "since February 2006, the largest hedge fund management companies have been required to register with the US Securities and Exchange Commission" (Stefanini 291). Registration has forced hedge funds to report regularly and comply with periodic inspections by commissioners (Stefanini 291). In the future it is predicted that it will be more difficult to find top-performing hedge fund managers as the supply of top-performing hedge fund managers is not meeting the rapidly growing demand for hedge funds; money is flowing into the hedge fund industry so fast that new talent is not meeting it fast enough (Stefanini 291).

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